PERFORMANCE PERSPECTIVES
with David Spaulding

VOLUME 6 – ISSUE 8 APRIL 2009

CUMULATIVE VS. ANNUALIZED

A client recently asked me to contrast cumulative and annualized returns. Many of us take these terms for granted, and assume their meaning and usefulness is clear, but perhaps this isn't always the case.

Cumulative reflects the return across the full period. If I invested $1,000 five years ago and today my portfolio is worth $2,000, then I've had a 100% return, yes?[1] So that's my cumulative return. However, what does this 100% convey to you? Does it sound like a good return? My suspicion is that as the length of the time period grows, its value diminishes. For example, what if I had a 100% cumulative return for a ten or twenty year period?

Annualized returns are essentially averages; granted, they're averages that take into consideration compounding, but they are still averages. And so, for my 100% cumulative return the five year annualized return is 14.87 percent, for a 10 year period it's 7.18% and it's 3.53% for 20 years.

An analogy might help as well. Let's use basketball for an example. Harvey Jones scored 3,000 points in his NBA career.[2] Is that a lot? Well, if he played for only a year and played 70 games, that would mean an average of 43 points a game, which would be quite an amazing feat; however if he played for ten years, 70 games a year, his average per game would drop to about four points a game, which would not be very good.

And so, while cumulative values (returns, points per game, etc.) have meaning, wouldn't you agree that averages have more meaning and value?

MADOFF & THE BEARDSTOWN LADIES

Someone recently contrasted Bernie Madoff's acts with the Beardstown Ladies.[3] Both reported extraordinary returns. However, in the latter's case this wasn't done intentionally; rather, it was merely a problem with data entry. To my knowledge no one ever accused these ladies of fraud or intentional wrongdoing. Bernie, however, is another matter.

AFTER AFTER-TAX IS NO MORE

As you may know the proposed changes to GIPS include the removal of the after-tax components. I believe this is being done chiefly because they are country-specific.[4] And because GIPS is a global standard there is a preference for no country-specific components. And, because a global set of after-tax standards might not be possible, the decision was apparently made to remove them.

1 Assuming no external cash flows.

2 Names are fictitious; NBA = National Basketball Association.

3 The Beardstown Ladies were an investment club whose amazingly high reported returns brought them much fame. However, it was later learned that due to data entry errors their performance was hardly anything to be excited about. See, for example, http://en.wikipedia.org/wiki/Beardstown_Ladies for more details.

4 There are two, one set for Italy and one for the U.S.

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Our involvement with the industry isn't limited to consulting. We're actively involved as members of the CFA Institute (formerly AIMR), the New York Society of Security Analysts (NYSSA), and other industry groups. Our president and founder regularly speaks at and/or chairs industry conferences and is a frequent author and source of information to various industry publications.

Our clients appreciate our industry focus. We understand their business, their needs, and the opportunities to make them more efficient and competitive.

For additional information about The Spaulding Group and our services, please visit our web site or contact Chris Spaulding at

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– John D. Simpson, CIPM, The Spaulding Group, Inc.

To me after-tax is something like the line from the 1989 movie *Field of Dreams*, "build it and they will come." Except, they didn't. After the rules were put forward very few adopted them. And why not? Probably a variety of reasons, such as:

- minimal software was available that supported them: because the after-tax rules are both an *accounting* and a *performance* issue, one must combine features and data from both, which can be a challenge.
- not a lot of interest from clients: the rules, of course, only apply to accounts that actually pay taxes, and since so many firms have only non-taxable accounts they wouldn't have a need for such reporting. And of those who do have taxable clients, many weren't being asked for after-tax results.
- limited number of tax aware managers: while many tax aware managers wish to report after-tax returns, most managers don't take taxes into consideration, or at least don't necessarily hold themselves out as being "tax aware." And while one might argue that the reporting still has value, regardless of what the manager's intent might be, there has to be pressure for them to take it on.
- difficulty in understanding the rules: the after-tax rules are complex and many wouldn't spend the time and energy to fully understand how they work. While Lee Price, Doug Rogers, and John Simpson are acknowledged experts on after-tax, there aren't many who come close to their level of expertise. Even some verifiers avoid dealing with after-tax because of its complexity.
- disagreement with the rules: as with many of the GIPS rules, there were many who didn't agree with what was being required and so avoided adopting them.

In spite of this, given the amount of work that went into these rules and given that there are firms who have adopted them, what's the harm in keeping them? Can there not be exceptions to the "no country specific rules" when it makes sense? But let's assume that the rules are dropped, what is a firm to do who wishes to continue to report after-tax results? So far there has been no suggestion regarding what the future will hold, but I can think of at least two options:

1. Firms will continue to be permitted to show after-tax returns but must be prepared to explain how they're arrived at. Such an explanation would likely be found in their policy on calculations and reporting. Firms would not be forced to abide by any specific rules but would be permitted to use the currently permitted rules, the prior AIMR-PPS® rules, or an approach they feel is appropriate.
2. Firms may show after-tax results as supplemental information. Again, there wouldn't be any rules regarding how this is to be done, but whatever method is employed would have to be documented.

We will have to wait for guidance on this, though I suspect that either of these ideas may be permitted. We know that there is a market for after-tax reporting, at least in the United States and Italy, and so it would be a shame to see a complete prohibition.

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PARDON OUR BREVITY

This issue is a bit shorter than normal because we decided to pull our lead topic (which ran to over two pages) after internal discussion as well as input from two of our colleagues who reviewed it for us. We felt that it needed some reworking and didn't have the time to devote to it right now. So, we're a bit briefer than normal but promise to have more to say next month.

KEEP THOSE CARDS & LETTERS COMING

We appreciate the occasional e-mail we get regarding our newsletter. Occasionally, we hear positive feedback while at other times, we hear opposition to what we suggest. That's fine. We can take it. And more important, we encourage the dialogue. We see this newsletter as one way to communicate ideas and want to hear your thoughts.

THE SPAULDING GROUP'S 2009 INVESTMENT PERFORMANCE MEASUREMENT CALENDAR OF EVENTS

DATE	EVENT	LOCATION
May 12-13, 2009	Introduction to Performance Measurement Training	Chicago, IL (USA)
May 14-15, 2009	Performance Measurement Attribution Training	Chicago, IL (USA)
May 20-21, 2009	PMAR VII Conference	Philadelphia, PA (USA)
June 11-12, 2009	Performance Measurement Forum	Stockholm, Sweden
August 24-25, 2009	CIPM – Principles Level Preparatory Training	New Brunswick, NJ (USA)
August 26-28, 2009	CIPM – Expert Level Preparatory Training	New Brunswick, NJ (USA)
September 15-16, 2009	Introduction to Performance Measurement Training	Boston, MA (USA)
September 17-18, 2009	Performance Measurement Attribution Training	Boston, MA (USA)
October 20-21, 2009	Introduction to Performance Measurement Training	San Francisco, CA (USA)
October 22-23, 2009	Performance Measurement Attribution Training	San Francisco, CA (USA)
November 12-13, 2009	Performance Measurement Forum	Rome, Italy
November 18, 2009	Trends in Attribution Symposium (TIA III)	Philadelphia, PA (USA)
December 3-4, 2009	Performance Measurement forum	Orlando, FL (USA)
December 8-9, 2009	Introduction to Performance Measurement Training	New Brunswick, NJ (USA)
December 9-10, 2009	Performance Measurement Attribution Training	New Brunswick, NJ (USA)

For additional information on any of our 2009 events, please contact Christopher Spaulding at 732-873-5700

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May 12-13, 2009 – Chicago, IL

September 15-16, 2009 – Boston, MA

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May 14-15, 2009 – Chicago, IL

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October 22-23, 2009 – San Francisco, CA

December 9-10, 2009 – New Brunswick, NJ

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IN-HOUSE TRAINING

The Spaulding Group has offered in-house training to our clients since 1995. Beginning in 1998, we formalized our training, first with our Introduction to Performance Measurement class and later with our Performance Measurement Attribution class. We now also offer training for the CIPM program. To date, over 2,000 individuals have participated in our training programs, with numbers increasing monthly.

We were quite pleased when so many firms asked us to continue to provide in-house training. This saves our clients the cost transporting their staff to our training location and limits their time away from the office. And, because we discount the tuition for in-house training, it saves them even more! We can teach the same class we conduct to the general market, or we can develop a class that's suited specifically to meet your needs.

The two-day introductory class is based on David Spaulding's book, Measuring Investment Performance (McGraw-Hill, 1997). The attribution class draws from David's second book Investment Performance Attribution (McGraw-Hill, 2003). The two-day Advanced Performance Measurement Class combines elements from both classes and expands on them.